



update

### Effects of Paying the Tax on a Roth Conversion from IRA Funds

You may pay the tax on a Roth conversion either from other funds or from the IRA funds you are converting. However, if you choose to pay from the IRA funds, those funds will not be considered part of the rollover. Therefore, they will be subject to early withdrawal penalties if you are under 59½ at the time of the withdrawal.

Payment of the tax from the IRA funds can severely limit the benefit of a conversion to a Roth by eroding the capital that can be invested. For example, in a conversion of a \$50,000 IRA to a Roth and paying the tax from the conventional withdrawal, only \$29,429 (amount left in the IRA after paying taxes and penalties) actually would get invested in the Roth account. The result, shown below in after-tax dollars, assumes a 6% interest rate and an accumulation period of 25 years.

Years Of Accumulation	Roth (Tax-Free)	Conventional (After Tax)
Rollover Amount	29,429	50,000
5	68,000	74,660
10	91,900	99,920
15	122,980	133,720
20	164,580	178,960
25	220,240	239,460

### Time Limits on Holding Converted Roth Accounts

When you convert a Traditional IRA to a Roth account, the converted amount must be held in the Roth IRA for at least five years; otherwise a penalty may apply. Any converted amount you withdraw before the end of the five-year period, to the extent it was included in income due to the conversion, is subject to a 10% early withdrawal penalty even if you have reached age 59½. After the five-year period has been satisfied, the 10% penalty still applies to distributions of earnings if you have not attained the age of 59½ or an exception applies.

*Any withdrawal you make from a Roth IRA containing converted amounts before the five-year holding period ends are treated as coming FIRST from amounts that were included in income due to the conversion.*

### Impact of Conversions on Other Tax Consequences

When you consider whether or not to convert to a Roth IRA, you must carefully consider how the move will increase your taxable income in the conversion year. The increase could have drastic effects on other tax consequences. For instance, the increase may:

- Limit the Hope and Lifetime Learning Credits allowed for higher education expenses;
- Cause more of your social security income to be taxed;
- Limit your losses on rental real estate; and
- Mean some of your itemized deductions will be phased out.

The income “catch” for Roth conversions can be averted with appropriate tax planning. That’s why it’s important to consult with your tax advisor before making a final Roth investment decision. Only by looking at your entire tax picture will you really be able to decide whether the Roth option is best for you.

### Factors That Favor Your Conversion to a Roth

- Your Traditional IRA has been open for a relatively short time.
- A large part of your Traditional IRA comes from nondeductible contributions.
- Roth accounts don’t require distribution at age 70½.
- You have other funds from which to pay the tax on the conversion.

### Factors That Don’t Favor Your Conversion to a Roth

- You may need to withdraw from the Roth account before meeting the five-year holding period.
- You have a short time until retirement and you expect to make withdrawals soon.
- You expect to be in a lower tax bracket when you withdraw from your IRA.
- You do not have other funds with which to pay the tax on the conversions.

### Saver’s Credit

The Retirement Savings Contribution Credit, frequently referred to as the Saver’s Credit, was established to encourage low to moderate income taxpayers to put funds away for their retirement.

Up to \$2,000 per taxpayer of contributions to an IRA (traditional or Roth) or other retirement plans, such as a 401(k), may be eligible for a nonrefundable tax credit that ranges from 10% to 50% of the contribution, depending on the taxpayer’s income. The maximum credit per person is \$1,000. The contribution amount on which the credit is based is reduced if the taxpayer (or spouse if filing jointly) received a taxable retirement plan distribution for the year for which the credit is claimed (including up to the return due date in the following year) or in the prior two years. If modified AGI exceeds \$25,000 (single), \$50,000 (married joint) or \$37,500 (head of household), no credit is allowed. An individual who is under age 18, a full-time student, or a dependent of someone else is ineligible. The credit, which applies for tax years 2002 through 2006, is in addition to any deduction allowed for traditional IRA contributions.

The purpose of this pamphlet is to provide current information on tax, financial, and business developments. It suggests general tax planning ideas that may be appropriate in certain situations. The information and opinions are generalizations and may not apply to all taxpayers; it is important that you seek appropriate advice before implementing any of the ideas suggested.

Client Information Series



# Roth IRA



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## The Roth IRA Advantage

Traditional IRAs are familiar to most taxpayers, providing a relatively simple method of saving for retirement AND deferring taxes in the process. But one drawback of the Traditional IRA is that once withdrawals from them begin, distributed earnings and contributions that were tax-deductible get taxed. In contrast, a Roth IRA allows no tax deduction of contributions. However, it does allow tax-free accumulation on the account so that at retirement ALL distributions from a Roth IRA are tax-free, both contributions and earnings. Naturally, to get this tax-free treatment, you must meet certain conditions.

## Predicting IRA Growth

The question always arises as to the future value of an IRA and the retirement income that it will produce. The future value for Rollover IRAs is dependent on whether the IRA will contain only rollover funds or whether additional annual contributions will be made to the IRA. Two tables follow, one including the future value of a rolled over sum and the second illustrating the future value of a \$1,000 annual contribution. By using the two tables and an assumed investment rate of return, it's possible to predict the future value of an IRA account, whether it be traditional or Roth.

## Lump Sum Accumulation

*\$1 Rolled Over "X" Years*

YRS	INVESTMENT RATE OF RETURN (ANNUALLY)					
	2%	4%	6%	8%	10%	12%
5	1.1041	1.2167	1.3382	1.4693	1.6105	1.7623
10	1.2190	1.4802	1.7908	2.1589	2.5937	3.1058
15	1.3459	1.8009	2.3966	3.1722	4.1772	5.4736
20	1.4859	2.1911	3.2071	4.6610	6.7275	9.6463
25	1.6406	2.6658	4.2919	6.8485	10.8347	17.0001
30	1.8114	3.2434	5.7435	10.0627	17.4494	29.9599
35	1.9999	3.9461	7.6861	14.7853	28.1024	52.7996
40	2.2080	4.8010	10.2857	21.7245	45.2593	93.0510

*Example: A rollover contribution of \$30,000 left to accumulate for 25 years at 6% will be worth \$128,757 (\$30,000 x 4.2919) at the end of the period.*

## IRA Growth with \$1,000 Annual Contribution

*For larger contributions, extrapolate the results.  
Example: contribute \$3,000 annually, simply triple the table results.*

YRS	INVESTMENT RATE OF RETURN (ANNUALLY)					
	2%	4%	6%	8%	10%	12%
5	5,204	5,417	5,637	5,867	6,105	6,353
10	10,950	12,006	13,181	14,487	15,938	17,549
15	17,294	20,024	23,276	27,152	31,773	37,280
20	24,298	29,778	36,786	45,762	57,275	72,053
25	32,031	41,646	54,865	73,106	98,347	133,334
30	40,568	56,085	79,058	113,283	164,494	241,333
35	49,995	73,652	111,435	172,317	271,025	431,664
40	60,402	95,026	154,762	259,057	442,593	767,092
45	71,893	121,030	212,744	386,506	718,905	1,358,230
50	84,580	152,667	290,336	573,770	1,163,909	2,400,018

*Example: \$2,000 annually contributed to an IRA earning 6% per annum would have a value of \$109,730 (54,865 x 2) after 25 years. Based on the two examples above, a taxpayer who rolled \$30,000 into an IRA and then continued to contribute \$2,000 a year to that IRA would have \$238,487 in the IRA account at the end of 25 years.*

## How Much Can You Contribute?

As with a Traditional IRA, to be eligible for a contribution to a Roth IRA, you (or your spouse, if you aren't employed or self-employed) must have taxable compensation like wages, earnings from a self-employed business, or alimony. After 2001, IRA contributions are no longer limited to \$2,000 as they have been for so many years in the past.

Year	Contribution Limits	
	Under Age 50	Age 50 and Over
Through 2001	2,000	2,000
2002 through 2004	3,000	3,500
2005	4,000	4,500
2006 through 2007	4,000	5,000
2008	5,000	6,000
2009 and after	Inflation Adjusted	

In addition, taxpayers age 50 and older are allowed to make "catch-up" contributions allowing them larger contributions in their later years to fund their approaching retirement needs. The table illustrates the annual contribution limit applicable to each year by age.

The annual limit applies to all of your IRA contributions in a given year. So, you can contribute to a Traditional IRA and a Roth IRA as long as the combined total does not exceed the annual IRA limits and you meet all of the other requirements.

Your income level can limit your Roth contributions. Contributions are gradually reduced (i.e., phased out) for married joint taxpayers with adjusted gross income (AGI) between \$150,000 and \$160,000. They're reduced for other taxpayers when AGI is between \$95,000 and \$110,000. The contributions of married separate taxpayers who lived together at anytime during the year are reduced when AGI is between \$0 and \$10,000.

With Traditional IRAs, you can't make contributions once you turn age 70½. However, there is no such age limit for making contributions to Roth accounts.

## Handling Roth IRA Distributions

Generally, distributions from a Roth IRA (unless due to a conversion from a Traditional IRA) are treated as coming first from contributions (principal) on which you have already paid the tax. Therefore, any distribution to the extent of the principal is tax-free. Distributions of earnings are also tax-free (qualified distributions) if:

They are not made within the five-year tax period beginning with the first tax year in which you contributed to the Roth account, AND

They meet one of the following conditions:

- They are made after you reach age 59½; OR
- They are made after your death; OR
- They are made on account of you becoming disabled; OR
- They are made so that you can pay up to \$10,000 in expenses as a first-time homebuyer.

Another big advantage of Roth IRAs over Traditional IRAs is that the former aren't subject to the minimum required distribution rules at age 70½. This means that if you don't need to utilize your Roth IRA for retirement, you can leave it untapped for heirs (who would also get deferral on withdrawals, but would be subject to certain required distribution rules that apply to beneficiaries).

## Conversions of Traditional IRAs to Roth Accounts

Because of the tax-free nature of Roth accounts, Congress has provided taxable rollover provisions that allow you to convert your Traditional IRAs to Roth accounts. Once you convert, all future earnings in the new Roth account accumulate tax-free. The catch is that you must pay the tax on the Traditional IRA in the year you make the conversion to the Roth. Whether it is beneficial for you to elect this taxable rollover depends on a number of variables.

The first year conversions were allowed (1998), there was a special election available to pay the tax over a four-year period. While this election no longer applies, you can still make a Traditional-to-Roth IRA conversion at any time. However, the conversion option is available to you (except if you file a married separate return) only if your AGI is \$100,000 or less. Because of this AGI limit, if you're not certain of what your AGI will be for a given year, you should hold off on making a rollover decision until you can safely estimate what your income is likely to be for the year. Keep in mind that your AGI, for the purpose of determining the limitation, DOES NOT include the taxable rollover amount.

## Paying the Tax on Conversion

The taxability of a Traditional IRA to Roth IRA conversion depends on whether or not you made nondeductible contributions to your Traditional IRA. If you did, your Traditional IRA includes amounts that have already been taxed. These post-tax contributions don't get taxed again when you convert to the Roth. However, you must pay the tax on any interest the Traditional IRA earned plus on contributions you were able to deduct prior to conversion.